95-543 EPW
Updated April 22, 1999

The Financial Outlook for Social Security and Medicare

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Summary

The 1999 annual reports of the board of trustees of the Social Security and Medicare trust funds were released on March 30, 1999. Both programs are shown to have long-range financing problems. Insolvency for the Disability Insurance (DI) part of Social Security is projected to occur in 2020, and for the retirement and survivors part, in 2036. On a combined basis, the two parts of Social Security would become insolvent in 2034, 2 years later than projected in last year's trustees' report. Insolvency of the Hospital Insurance (HI) part of Medicare is projected to occur in 2015, 7 years later than projected last year (14 years later than projected in 1997). Both the Social Security and Medicare programs have benefitted from an improved economic outlook in the near term. However, more pronounced for Medicare is a reduction in the long-range HI deficit attributed to constraints in reimbursement of Medicare providers as well as other changes enacted as part of the Balanced Budget Act of 1997 (P.L. 105-33). The trustees estimate that these changes cut the average (75-year) HI deficit by almost one-third (two-thirds compared to the average deficit projected in 1997).

Currently, combined expenditures for Social Security and Medicare are higher than the taxes and premiums collected to support them, and even with the recent improvement in the condition of the two programs, expenditures are projected to remain higher than receipts indefinitely. While income is projected to hover around 7% of gross domestic product (GDP) well into the future, costs would rise from 7.0% today to 11.7% in 2030.

Overview of the Outlook for Both Programs

Social Security's financial condition is assessed annually by its 6-member board of trustees, comprised of the Commissioner of Social Security, three members of the President's Cabinet, and two representatives of the public. For a number of years, the board's reports have projected long-range financing problems for the cash benefit system.

Projected Points of Insolvency

Social Security—	
Disability	2020
Retirement & survivors	2036
Disability & retirement combined	2034
Medicare—	
Hospital insurance	2015

Although the trustees' 1999 report continues to show a near-term buildup of trust fund reserves, their "best estimate" for the next 75 years shows that on average Social Security's expenditures will be 15% more than its income. The buildup would peak at $4.5 trillion in 2021, and then be drawn down as the post-World War II baby boomers retire. The trustees estimate that the disability fund would be exhausted in 2020 and the retirement fund in 2036. On a combined basis, the two trust funds would be exhausted in 2034. At that point, revenues would be sufficient to pay 71% of benefits.

Although the estimates imply that Social Security can be kept solvent for 35 years, the trustees project that the program's taxes would begin lagging expenditures in 2014. At that point, the program would begin relying in part on general revenues in the form of interest payments to the trust funds. By 2022, interest payments and tax revenues would no longer be sufficient to cover the program's expenditures, and the balances of the trust funds would begin to be drawn down. These reserves consist exclusively of Treasury bonds. By 2025, $1 out of every $5 of the program's outgo would be dependent upon these claims against the general fund. Expressed as an equivalent portion of today's annual expenditures, these claims would total $86 billion. The government has never defaulted on the bonds it records to its trust funds, but the magnitude of future claims has prompted many observers to ask where the government will get the money to cover them.

The picture is more troublesome for Medicare. The HI part of the program is projected to become insolvent in 2015. On average over the next 75 years, its costs would be about 45% higher than its income. While Supplementary Medical Insurance (SMI), the part of Medicare that pays for physician care, is smaller and does not have HI's financing problems (it relies heavily on annual general revenue payments, not a fixed tax rate), inflation and the rising demand for medical care as society ages are causing its costs to rise rapidly. As a share of GDP, SMI's costs are projected to double by 2020.

Background

Social Security is the Nation's largest retirement and disability program providing cash benefits to 44 million retired and disabled workers and to their dependents and survivors. Medicare provides 39 million of them with health insurance. In 1996, Social Security accounted for an estimated 46% of the income of the elderly living in single-person households; 33% for those in multi-person households. Medicare provided more than 95% of the elderly with basic health coverage. Today, 1 out of 6 Americans receives Social Security; 1 out of 7 receives Medicare. The estimated 153 million workers whose taxes support the two programs in 1999 represent 1 out of 2 persons in the population.

Workers gain eligibility for Social Security and HI by working in jobs where Social Security and HI taxes are levied. They pay a flat-rate tax of 7.65% on their earnings (6.2% for Social Security and 1.45% for HI), which is matched by their employers. The self-employed pay a tax of 15.3% (with adjustments that effectively reduce the rate). The Social Security portion is levied on earnings up to $72,600 in 1999; the HI portion is levied on all earnings. About 78% of these taxes goes toward Social Security; the rest

goes toward HI. In 1999, payroll taxes comprise 90% of Social Security's estimated income and 89% of HI's estimated income. The rest comes mostly from government credits, the largest of which is for interest on federal securities held by their trust funds. There is no SMI tax; 77% of its estimated 1999 income comes from general revenues of the government and 23% from premiums paid by enrollees ($45.50 per month in 1999).

The taxes and premiums people pay flow into the Treasury, with each program's share credited to separate trust funds (one for retirement and survivors benefits, another for disability, and two others for Medicare). When the government receives the money, it records new interest-bearing federal securities to the appropriate fund (these securities earn interest at the same as the average rate prevailing on outstanding federal bonds with a maturity of 4 years or longer); when it makes payments, it writes some off. These securities represent obligations that the government has issued to itself. In effect, they are not assets for the government, but claims against it. Their primary role is to be reserve "spending authority." What this means is that as long as a trust fund has a positive balance, the Treasury Department is authorized to make payments for it from the Treasury; the fund itself does not contain the resources to do so.

The Social Security Picture

For more than three decades after Social Security taxes were first levied in 1937, the system's income routinely exceeded its outgo, and its trust funds grew. However, the situation changed in the early 1970s. Enactment of major benefit increases in the 1968 to 1972 period was followed by higher inflation and leaner economic growth than had been expected. Prices rose faster than wages, the post-World War II baby boom ended precipitously (leading to a large cut in projected birth rates), and Congress adopted faulty benefit rules in 1972 that overcompensated new Social Security retirees for inflation. These factors combined to sour the outlook for Social Security and it remained poor through the mid-1980s. Before 1971, the balances of the trust funds had never fallen below 1 year's worth of outgo. Beginning in 1973, the program's income lagged its outgo and its trust funds declined rapidly. Congress had to step in five times to keep them from being exhausted. Although major changes enacted in 1977 greatly reduced the program's long-run deficit, they did not eliminate it, and the short-run changes made by the legislation were not large enough to enable the program to withstand back-to-back recessions in 1980 and 1982. A disability bill in 1980 and temporary fixes in 1980 and 1981 were followed by another major reform package in 1983.

These 1983 changes, along with better economic conditions, helped to alter the picture. Income began to exceed outgo in 1983 and the trust funds grew substantially. Cumulatively, the changes were projected to yield $96 billion in surplus income by 1990, and to raise the trust funds' balances to $123 billion. The funds actually were credited with $200 billion in surplus income by 1990, and their balances reached $225 billion by the end of that year. Under the trustees' 1999 "intermediate" forecast (the one cited as their "best estimate"), surplus income of $791 billion is projected for the 1991 to 2000 period, and the trust funds' balances would rise to $1 trillion by the end of 2000. This is equivalent to 238% of estimated expenditures in 2001 (or almost 2 ½ years' worth).

The long-range picture for Social Security (viewing the retirement and disability parts of the program as if they were one) has worsened considerably since 1983. By raising Social Security's age for full benefits from 65 to 67, subjecting benefits to income taxes, and making federal and nonprofit workers join the system, Congress had attempted in 1983 to eliminate the long-run problem. In fact, projections made then showed that it had, at least on average, for the following 75 years. However, the *average* condition of the two trust funds did not represent their condition over the entire period. The funds were not shown to be insolvent at any point, but their expenditures were expected to exceed their income in 2025 and to remain higher thereafter. Simply stated, 40 years of surpluses were to be followed by an indefinite period of deficits. With each passing year since 1983, the trustees' 75-year averaging period has picked up 1 deficit year at the back end and dropped a surplus year from the front end. This, by itself, would cause the average condition to worsen. In subsequent reports, however, assumptions about birth rates, economic growth, and wages were lowered, causing further deterioration in the outlook. A small long-range deficit appeared in the 1984 report and the gap grew larger (with the point of insolvency generally coming closer) in subsequent reports. Projections reported the last 2 years, however, have shown small improvements largely due to favorable near-term economic conditions. The 1999 report shows an average 75-year deficit equal to 15 percent of the program's income, and projects that the trust funds on a combined basis would become insolvent in 2034 (2 years later than last year's projection). As a percent of the Nation's payrolls, their income would average 13.49%, their outgo, 15.56%, and the deficit would be 2.07% (compared to 2.19% in the 1998 report). The average deficit currently projected for Social Security is about the same as the Social Security deficit tackled by Congress in 1983.

These long-range projections assume that GDP (adjusted for inflation) will rise annually at rates ranging from 2.6% in 1999 to 1.3% in 2050, wages would rise at an ultimate rate of 4.2% per year, the cost of living would go up at a rate of 3.3%, unemployment would average 5.5%, and that Social Security benefits would fall in relative terms as the age at which full benefits are payable rises from 65 to 67 over the 2000 to 2022 period. The higher age for full benefits will mean that people retiring at age 67 or younger will get less than under the previous rules. These assumptions by themselves would seem to bode well for the system; however, looming demographic shifts are projected to overwhelm them. During the next two decades, the baby boomers will be in their prime productive years, and the baby-trough generation of the 1930s will be in retirement. Together these factors will lead to a stable ratio of workers to recipients. However, as the baby boomers begin retiring around 2010, this ratio will erode quickly. By 2025, most of the surviving baby boomers will be 65 and older. The number of people 65 and older will have risen by 75%, growing from 35 million today to 61 million then. The number of workers will have grown from 150 million to 170 million, or by only 13%. Consequently, the ratio of workers to recipients will have fallen from 3.4 to 1 today to 2.2 to 1 in 2025 (and, by 2035, 2 to 1).

Under this forecast, the trust funds (on a combined basis) would be credited with surplus income through 2021 bringing their balances to a level of $4.5 trillion. They would decline in 2022 and thereafter, and would be depleted by 2034. However, tax receipts begin lagging outgo much sooner, in 2014. At that point, the program would have to rely on the interest credited to its trust funds for part of its income, which would have to be

funded from general revenue. In 2022, the reserve balance of the trust funds would begin to be drawn down. By 2025, $1 out of every $5 of the program's outgo would be dependent upon general fund expenditures for interest payments and the redemption of the government bonds in the trust funds. The government has never defaulted on the securities it posts to its trust funds, but the magnitude of these potential claims has prompted many observers to ask where the government will find the money to cover them. Basically, in the absence of surpluses for the rest of the government's operations, policymakers would have three options: raise other taxes, curtail other spending, or borrow money from the financial markets. There is nothing in the law that will dictate or determine what it actually will (or can) do then.

Economists argue that if the surplus taxes projected for the next 15 years were to cause the government to reduce the federal debt held by the public, more money would be available in the financial markets for investment, which could lead to greater economic growth. If this occurred, extracting resources from the economy in the future to honor Social Security claims would not necessarily be so burdensome. Said another way, if one accepts the premise that reductions in the federal debt held by the public today will increase the resources available for investment, then surplus Social Security taxes today could help build a higher economic base from which to draw the needed resources.

However, rolling surplus Social Security taxes into Treasury bonds will not by itself reduce government borrowing from the markets. Reductions in the debt occur when the government runs an overall or unified budget surplus, not when one of its programs generates surplus taxes. However, even if economic growth were enhanced in the coming decades by reductions in government debt, Social Security's problems would not necessarily be resolved. Its costs would grow as the economy grows (since economic growth would likely result in higher wages, which in turn would lead to larger benefit claims). Further, as their numbers swell, the baby boomers and subsequent retirees will raise financial demands on all retirement systems, not only Social Security. The goods and services to be consumed by society cannot be stockpiled in advance, and the economy will have to adjust. Whether the adjustment would be mild or severe is mostly conjecture.

The Medicare Picture

The trustees present a more troublesome picture for Medicare. Although major constraints in Medicare payment rates were enacted as part of the Balanced Budget Act of 1997 (P.L. 105-33), HI's rapid growth is projected to continue indefinitely. The changes extended the HI trust funds' projected insolvency point by 14 years (from 2001 to 2015), and cut the average 75-year deficit by almost one-third (from 2.10% to 1.46%); however, the remaining deficit is large. On average, HI's costs would be about 45% higher than its income. By 2070, its costs would be 2 times as large as its income. This pessimistic outlook reflects a generally aging population, the impact of the post-World War II baby boomers' retirement early in the next century, the persistent high rate of inflation in the health sector of the economy, and growth in the quantity of services provided. Most significant are looming demographic shifts. Where there are 3.9 workers per HI beneficiary in 1999, there will be an estimated 2.3 workers per beneficiary in 2030.

Shown as a percent of the Nation's payrolls, HI's costs would rise from 3.1% today to 5.09% in 2030 and 6.78% in 2070. On average for the 75-year period, HI income would be 3.26% of payroll, HI outgo would be 4.71%, and the deficit would be 1.46%. Although the long-range HI deficit is smaller than that for Social Security, the HI problem is larger given the size of each program. The average gap between HI's income and outgo equals 45% of the program's income in contrast to a gap of 15% for Social Security.

Since SMI is financed with general revenues and premiums that are determined and reset annually, it does not have an explicit financing problem like HI. However, inflation and the rising demand for medical care as society ages are causing its expenditures to rise even faster than HI's. Projections show that SMI's expenditures as a share of GDP would double by 2020 (rising from .98% today to 1.97% in 2020). From 1999 to 2070, the combined costs of HI and SMI are projected to rise from 2.55% of GDP to 5.67%.

The Combined Scenario

The trustees' 1999 projections provide some basis to think that Social Security overall will generate sufficient taxes to cover its commitments for the next 15 years. The long-range outlook, however, leaves little to be sanguine about; the program faces a sizeable 75-year funding gap. HI's problems are more imminent, as insolvency is projected for 2015. Resources could be reallocated to HI from Social Security; however, this would only move Social Security's problems closer. If Social Security and HI are considered together, their outgo as a percent of the Nation's payrolls would rise from 13.9% today to 22.8% in 2030, a level that contrasts sharply with a combined tax rate that is set now in the law at 15.3%. As a percent of GDP, outgo for Social Security and HI combined would rise from about 6.0% today to 9.3% in 2030; including SMI would raise it from 7.0% to 11.7%. However, the taxes and premiums dedicated to support all three programs (i.e., payroll taxes, income from the taxation of benefits, and SMI premiums), which are now less than combined program expenditures, are projected to hover only in the 7% range throughout the period.

These projections are *not* based on pessimistic economic assumptions. A modest but sustained rise in GDP and moderate inflation and unemployment are assumed. Moreover, they hinge in large part on demographic factors that are in place today — the post-World War II baby boom, the subsequent birth dearth, and the general aging of society. They suggest that to restore long-run solvency, income needs to be raised, expenditures cut, or some combination thereof. Beyond possible changes to the programs themselves, important unknowns that can alter the outlook include: whether an effective means can be found to rein in the spiraling cost of medical care generally and whether future technological advances will propel productivity. Also unknown and little understood is the effect of potential shifts in society's wants and needs: from raising families, buying houses, and educating children to meeting the health and service demands of an older population. Will the higher future costs of Social Security and Medicare place a large strain on the economy or merely reflect a shift of the Nation's consumption priorities?